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BEFORE THE ARIZONA CORPORATION COMMISSION

AZCORP
2016 DEC 28

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COMMISSIONERS

DOUG LITTLE - CHAIRMAN
BOB STUMP
BOB BURNS
TOM FORESE
ANDY TOBIN

IN THE MATTER OF THE APPLICATION
OF ARIZONA PUBLIC SERVICE
COMPANY FOR A HEARING TO
DETERMINE THE FAIR VALUE OF THE
UTILITY PROPERTY OF THE COMPANY
FOR RATEMAKING PURPOSES, TO FIX
A JUST AND REASONABLE RATE OF
RETURN THEREON, TO APPROVE
RATE SCHEDULES DESIGNED TO
DEVELOP SUCH RETURN.

DOCKET NO. E-01345A-16-0036

IN THE MATTER OF FUEL AND
PURCHASED POWER PROCUREMENT
AUDITS FOR ARIZONA PUBLIC
SERVICE COMPANY.

DOCKET NO. E-01345A-16-0123

Direct Testimony and Exhibits of

BRANKO TERZIC

on Behalf of

Arizona Investment Council

December 21, 2016

Arizona Corporation Commission

DOCKETED

DEC 28 2016

DOCKETED BY

GP

OSBORN
MALEDON

A PROFESSIONAL ASSOCIATION
ATTORNEYS AT LAW

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1 **I. INTRODUCTION AND PURPOSE**

2 **Q. Please state your name, address, and occupation.**

3 A. My name is Branko Terzic. I am a Managing Director at the Berkeley Research
4 Group LLC. My business address is 1800 M Street N.W. Washington, DC,
5 20036.

6
7 **Q. What is your educational and professional background?**

8 A. I received a B.S. in Energy Engineering from the University of Wisconsin-
9 Milwaukee in 1972 and was awarded an honorary Doctor of Sciences in
10 Engineering, also from the University of Wisconsin-Milwaukee, in 2009.

11
12 I am a managing director at Berkeley Research Group LLC (“BRG”) in
13 Washington, DC. I am also a Nonresident Senior Fellow at the Atlantic Council
14 in Washington DC.

15
16 Prior to joining BRG, I served as the Executive Director of Deloitte Center for
17 Energy Solutions (2011-2014), a Global and U.S. Regulatory Policy Leader in
18 Energy & Resources for Deloitte Services (1999-2014) and a Regional Managing
19 Partner for Energy, Resources and Infrastructure for Deloitte & Touche Central
20 Europe (1999-2004).

21
22 I was Chairman, President and CEO of Yankee Energy System, Inc. (1994-1999),
23 Managing Director at Arthur Andersen Economic Consulting (1993-1994),
24 Commissioner on the Federal Energy Regulatory Commission (1990-1993),
25 Group Vice President at AUS Consultants (1987-1990), Commissioner on the
26 State of Wisconsin Public Service Commission (1981-1986), Partner in Terzic &
27 Mayer Public Utility Consultants, Vice President at Associated Utility Services,
28 Inc., Valuation Engineer at the American Appraisal Company, and Special

1 Investigations Engineer and Environmental Engineer for the Wisconsin Electric
2 Power Company.

3
4 I have been a member of the National Petroleum Council and National Coal
5 Council, and I am a former Chairman of the United Nations Economic
6 Commission for Europe (UN ECE) Ad Hoc Group of Experts on Cleaner
7 Electricity Production (2007-2012).

8
9 I have published articles in numerous energy and finance publications including
10 magazines for the Electric Edison Institute (“EEI”) and American Gas
11 Association (AGA), as well as Public Utilities Fortnightly, Oil & Gas Investor,
12 and others. My bi-weekly column *Terzic on Strategy* was published from 1999 to
13 2009 in *New Power Executive*. I now write a monthly column in *Public Utility*
14 *Fortnightly* magazine.

15
16 I have appeared many times on CNN International and have appeared as a
17 commentator on numerous TV news programs including CNN, CNBC, Fox
18 Business, PBS, Voice of America, and Al Jazeera.

19
20 I also authored a chapter on energy for the book THE WORLD CRISIS: The Way
21 Forward After Iraq (Constable, London 2008), edited by Robert Harvey.

22
23 I was elected to the Energy Efficiency Forum Hall of Fame in 2009 and was
24 honored with the “Champion Award” by The Women’s Council on Energy and
25 Environment (2008), among other awards.

26
27 I have been a faculty member at the Washington Campus consortium of sixteen
28 university MBA programs since 2005. I am a founder of the Society of

1 Depreciation Professionals. I have served on the board of the National
2 Regulatory Research Institute and I am a past chairman of the Natural Gas
3 Roundtable.

4
5 **II. ACCOUNTING ORDERS FOR PROJECTS AT FOUR CORNERS**
6 **GENERATION STATION AND OCOTILLO MODERNIZATION**
7 **PROJECT**

8 **Q. What is the purpose of your direct testimony in this proceeding?**

9 A. The purpose of my testimony is to support and advocate for the adoption of two
10 accounting orders requested in Arizona Public Service's ("APS") Rate
11 Application. The first accounting order would allow APS to defer the costs for
12 the selective catalytic reduction ("SCR") equipment at the Four Corners
13 Generating Station ("Four Corners") until installation is complete. Upon
14 completion, APS would institute a step rate increase in January 2019 to begin
15 recovery of the deferred SCR costs.

16
17 The second accounting order would allow APS to defer the non-fuel costs of
18 owning, operating and maintaining the Ocotillo Modernization Project
19 ("OMP") until it can be included in revenue requirement as part of a subsequent
20 rate case. The OMP accounting order would have no effect on the
21 Commission's approved revenue request in this rate application, but would
22 have beneficial effects for customers and investors in the period between this
23 rate case and the next.

24
25 **Q. What is APS's accounting order proposal regarding SCR investments at**
26 **Four Corners?**

27 A. APS plans to begin installation of the SCRs in late 2017 and the beginning of
28 2018 – a mere six months after the conclusion of this rate case proceeding and

1 slightly too late to be included as part of post-test year plant. Therefore, to avoid
2 filing back to back rate cases, APS is requesting approval of an accounting order
3 that would defer certain costs associated with the SCRs from the time they are
4 installed until December of 2018, at which time APS proposes to include them in
5 rates through a January 2019 step increase. This treatment is similar to the
6 procedure authorized in APS's 2012 Settlement Agreement.¹
7

8 **Q. What is APS's accounting order proposal to defer costs associated with**
9 **OMP?**

10 **A.** Like the investment in SCRs for Four Corners, the investment that APS is making
11 with respect to OMP does not align with the timing of the present rate case: two
12 of the five new OMP units are expected to go into service in the fall of 2018 and
13 the other three will be placed in service in the spring of 2019. Therefore, to avoid
14 the filing of back to back rate cases, APS is requesting that the Commission issue
15 an accounting order that allows the Company to defer certain costs associated
16 with the OMP from the date of its commercial operation in 2018 and 2019 to the
17 effective date of the new rates approved in APS's next rate case. APS is neither
18 seeking rate recovery for OMP at this time nor is it seeking a prudence
19 determination on that investment in this rate case. In its request, APS proposes to
20 defer and capitalize for potential future recovery all non-fuel costs of owning,
21 operating and maintaining OMP, as well as retiring the existing steam generation.
22 APS estimates that the total deferral amount through 2019 will be \$45 million.
23

24 **Q. Why is an accounting order appropriate for known large investments**
25 **undertaken by utilities between rate case test years?**

26 **A.** Accounting orders help companies mitigate the negative financial consequence of
27 regulatory lag that results from making significant capital investment in large
28

¹ Decision Nos. 73183 (May 24, 2012) and 74876 (December 23, 2014).

1 projects without impacting current customer rates. Due to the timing of both the
2 installation of the SCRs and the construction of OMP, APS will not have an
3 opportunity to include either of the projects in its revenue requirement request in
4 the present rate case. However, both projects will be in operation and serving
5 customers shortly after this rate case concludes. This means that, absent an
6 accounting order, expenses are booked as incurred, immediately lowering APS's
7 reported earnings even under the new rate structure. The resulting revenue
8 requirement deficiency would force APS to submit a new rate case filing almost
9 immediately upon the conclusion of this rate case, and then others thereafter as
10 needed to recover the investment in OMP and the SCRs.

11
12 The Commission-approved accounting order requested here would allow APS to
13 delay recording certain of the expenses associated with the OMP and SCRs until
14 the assets are in service and the Company is authorized to collect a revenue
15 requirement that includes those costs (assuming that the Commission finds that
16 the investments were prudently incurred). This type of accounting order is
17 necessary to reconcile the unique characteristics and requirements of utility
18 ratemaking with Generally Accepted Accounting Principles ("GAAP"). Simply
19 put, an accounting order authorizing the requested deferral more accurately aligns
20 the costs and benefits of the investments made on behalf of APS customers.

21
22 Approval of the accounting order requests is appropriate as a matter of sound
23 regulatory policy. It sends a positive message to the industry and Wall Street that
24 the Commission supports the financial integrity of the Company through periods
25 of high capital expenditures. It also promotes rate gradualism and prevents the
26 Company from having to file back to back rate applications – an end that benefits
27 the Company and its customers, the Commission, and all other stakeholders to
28 APS rate proceedings. As a former regulator, I believe the current request is

1 reasonable and would be consistent with the Commission's past determinations
2 and orders.

3
4 **Q. How is approval of the requested accounting orders consistent with the**
5 **Commission's past determinations and orders?**

6 A. This Commission has approved accounting orders such as those requested here on
7 multiple occasions. APS alone has been granted quite a few accounting orders.
8 For example, the Commission authorized APS to defer certain costs associated
9 with the acquisition of the Sundance Generating Station in 2005, the construction
10 and maintenance of Palo Verde Units 2 and 3 in 1986 and 1988, and, more
11 recently, when APS acquired Southern California Edison's share of the Four
12 Corners Power Plant.²

13
14 **Q. Why do you believe that the two accounting orders requested by APS in this**
15 **rate case are appropriate?**

16 A. Approval of the accounting orders proposed in this case would benefit both APS
17 and its customers because it would send a positive signal to the financial industry
18 that the Commission supports a financially healthy utility and uses regulatory
19 tools as needed to mitigate the impact of regulatory lag between rate cases.

20
21 In addition, as a former regulator and utility CEO, I believe that the
22 Commission's approval of the requested accounting orders would send a positive
23 signal to capital markets demonstrating a continuation of the Commission's prior
24 policies, thus indicating a consistency of regulatory approach.

25
26
27
28 ² See Decision Nos. 67504 (January 20, 2005), 55325 (December 5, 1986), 55939 (April 6, 1988), and
73130 (April 24, 2012).

1 Additionally, approval of the accounting orders alleviates the need for APS to file
2 back to back rate cases and would promote the principle of gradualism. APS
3 customers will receive a rate increase in the summer or fall of 2017, a very small
4 increase in the beginning of 2019, and then a less steep increase a couple of years
5 later than they would have received but for the 2019 step increase.
6

7 In the case of the SCR expenditures, I believe that the collateral request for
8 approval of a one-step increase now to cover the revenue requirement impact of
9 the SCR installation in two years has multiple benefits. First, the Commission
10 has the opportunity, in this case, to review the full record on the SCR project.
11 Second, a step increase avoids the necessity for a full near term rate case and all
12 of its accompanying costs on regulation. Third, the Commission would be
13 following its own prior precedent in Decision No. 74876 (approval of the step
14 increase associated with the acquisition of SCE's share of Four Corners power
15 plant), thus providing that consistency of regulation so important to companies
16 and their shareholders.
17

18 **Q. Why is regulatory consistency desirable?**

19 **A.** As a former regulator, and as someone who lectures on regulatory policy around
20 the world, a theme I include in my classes is the benefit of regulatory consistency
21 (sometimes referred to as "stability" or "predictability" of regulation). The
22 concept is simple: application of the same laws, under similar circumstances and
23 similar facts, should produce the same results.
24

25 Consistency of regulatory treatment is closely linked to regulatory risk.
26 Predictability reduces business risk, which can increase a company's
27 creditworthiness. That end, in time, lowers a company's cost of capital,
28 ultimately resulting in lower rates for customers. Professor Roger Morin

1 described the idea succinctly when he said, “[r]egulation can compound the
2 business risk premium if it is unpredictable in reacting to rate hike requests both
3 in terms of the time lag of its response and its magnitude.³
4

5 APS’s application accurately described the benefits accruing to the Company’s
6 bond rating in 2015 because of its 2012 Settlement Agreement, in which the
7 Commission approved multiple requests for accounting orders. The approval of
8 APS’s current request for similar accounting orders would send an equally
9 positive signal to capital markets and the industry that the Commission’s
10 regulatory policies continue to be consistent and positive with respect to returns
11 on capital investment.
12

13 **Q. Why is regulatory uncertainty undesirable?**

14 A. Utility rate regulation is unique compared to price setting in the general
15 marketplace. While regulated electric utilities face many, but not all, of the risks
16 experienced by competitive enterprises, they do have a unique risk regarding
17 uncertain or inconsistent regulation. Historically, uncertainty (due to regulatory
18 lag, for example) has led to both lower achieved earnings for investors and higher
19 costs of capital for the consumer. Specifically regulatory lag, “increases the
20 uncertainty as to the realized rate of return and thereby raises the cost of capital,”
21 for the utility.⁴
22

23 While regulatory inconsistency and regulatory lag may be risk factors, public
24 utility commissions like the Arizona Corporation Commission that propound
25 consistent policies and provide consistent analyses and recommendations help
26 mitigate the appearance of regulatory risk. The Commission has historically

27 ³ Morin, Roger. Regulatory Finance: Utilities’ Cost of Capital (PUR 1994) at page 39.

28 ⁴ Gordon, Myron J. The Cost of Capital to a Public Utility. (Michigan State University 1974) at page 211.

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approved accounting orders to prevent injustice where appropriate. Public policy supports consistency in the Commission's application of accounting orders and approval of APS's requests here.

III. CONCLUSIONS

Q. Does this conclude your testimony?

A. Yes, it does.